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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-309

TOUCHE ROSS & CO.,

Petitioner,

v.

EDWARD S. REDINGTON, as Trustee for the Liquidation of the business of WEIS SECURITIES, INC., and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

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BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae* pursuant to Rule 42(2) of the Rules of this Court,[1] addressed to certain issues specified below, and urges this Court to reverse the Order of the United States Court of Appeals for the Second Circuit entered in these proceedings on April 21, 1978, which Order reversed the judgment entered by the District Court for the Southern District of New York dismissing the Complaint herein.

[1] Letters of the petitioner and respondents giving their consent to the filing of this brief have been filed with the Clerk of this Court.

Opinions Below

The opinion of the majority of the Court of Appeals (Lumbard and Timbers, C.J.J.) reversing the decisions of the District Court and remanding the case and the dissenting opinion (Mulligan, C.J.), [Current] CCH Fed. Sec. L. Rep. ¶ 96,404 (2d Cir. 1978), are not officially reported and are printed in the Appendix to the Petition for Certiorari. The Opinion of the District Court dismissing the complaint is reported at 428 F. Supp. 483 (S.D.N.Y. 1977).

Question Presented

The Institute as *amicus curiae* addresses solely the first question upon which this Court has granted certiorari. That issue may be restated as follows:

> Should a private right of action for damages be judicially implied under Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q (the "1934 Act") and Rules 17a-5 promulgated thereunder, 17 C.F.R. § 240.17a-5, in favor of brokerage house customers against accountants in connection with their opinion regarding allegedly false or misleading financial statements of the broker, absent any allegation that the customers purchased or sold securities in reliance on the allegedly erroneous statements?[2]

Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants;

[2] The Institute has not formulated and does not express any position with respect to the other issues presented by petitioner.

it has approximately 130,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of standards and procedures in its field. Most particularly, the Institute develops the auditing standards which, after formal approval by vote of its members, are deemed "generally accepted" and which form the backdrop of this litigation.

The Institute accordingly has an obvious interest in the scope and bases of civil liability for damages sought to be imposed, under the rubric of Section 17(a), on auditors in connection with their performance of engagements governed by such generally accepted auditing standards. The Institute was invited to and did submit a position paper to the United States Senate concerning the scope of civil liability and damages to be provided in the 1934 Act *(Hearings on S. Res. 84 (72 Cong.) and S. Res. 56 and S. Res. 97 Before the Committee on Banking and Currency of the United States Senate,* 73d Cong., 1st Sess., pt. 15 at 7207-10 (1934) (hereinafter cited as *1934 Hearings*)) and was accorded permission by this Court to file a brief *amicus curiae* in support of the petition for a writ of certiorari in this case.

The holding below that customers who neither purchased nor sold securities in reliance on allegedly erroneous financial statements have standing to invoke a private cause of action under Section 17(a) and the unsatisfactory analysis upon which that holding was reached transcend the interests of the parties litigant and are of profoundly disturbing significance to the accounting profession as a whole.

The Institute here contends that the holding below frustrates congressional intent as derived from the statute

and legislative history, is unnecessary to achieve the purposes Congress sought to achieve in creating the reporting provisions, and creates, with respect to Section 17 and the other reporting provisions of the 1934 Act, an indeterminate liability to an undefined class without any Congressional definition of the contours of such liability.

Statement

Weis Securities, Inc. ("Weis"), a defunct brokerage firm, was liquidated in 1973 pursuant to the provisions of the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa *et. seq.* ("SIPA"). The Trustee of Weis and the Securities Investor Protection Corporation ("SIPC") commenced this action for damages in 1976 in their own rights and respectively as bailee of Weis customers' property and as subrogee of the rights of Weis customers whose claims were paid by SIPC. They alleged that Touche Ross & Co., the accounting firm which audited Weis' financial statements in the years prior to Weis' bankruptcy, rendered a false or misleading opinion regarding those statements in violation of Section 17(a) of the 1934 Act and SEC Rule 17a-5.

Neither of the plaintiffs, nor the customers whose claims they claim to represent, asserts injuries arising out of a purchase or sale of securities. Rather, each relies on the theory that Weis' false and misleading financial statements prevented SIPC from taking appropriate actions to ward off financial collapse.[3] The Trustee and SIPC commenced

[3] Immediately following the discovery of Weis' financial condition in 1973, the SEC brought an action against Weis and certain of its officers seeking injunctive relief alleging violations of the securities acts. Further, an indictment was filed against former Weis officers in *United States* v. *Arthur Levine, et al.* alleging violations of the securities acts and fraudulent concealment.

an identical action against Touche Ross & Co. in the New York State courts asserting common law claims of accountants' negligence and malpractice in July 1975, almost one year prior to the commencement of the federal action.[4]

The majority of the court below determined that a private right of action exists under Section 17(a) of the 1934 Act in favor of brokerage house customers against an accounting firm on the basis of the latter's opinion concerning the broker's allegedly false financial statements, notwithstanding the customers' failure to purchase or sell securities in reliance on those statements. To reach this conclusion the Court of Appeals necessarily and expressly rejected the District Court's holding that Section 18(a) of the same act, which provides explicit remedies for violations of the reporting provisions of the 1934 Act including Section 17(a),[5] is the exclusive source of private remedies for any such violation.

Judge Mulligan forcefully dissented on the grounds that the implication of a private cause of action under Section 17(a) in favor of plaintiffs who would have no standing under Section 18 of the 1934 Act violated this Court's teachings regarding statutory construction and was superfluous in view of state law remedies.

[4] In the state court action, the parties are continuing with discovery. (Appendix to Petition for Certiorari at 6a, n.7).

[5] Other reporting sections of the 1934 Act are Sections 12(b), 12(g), 13, 15(b)(1), 15(d), 15A(a), and 16(a). They have in common the underlying purpose that disclosure be afforded through required filings made with the SEC.

ARGUMENT

I.

Implication of a private right of action pursuant to Section 17 of the 1934 Act in favor of persons who neither purchased nor sold securities at a price affected by the allegedly false or misleading statements sharply conflicts with the text of the 1934 Act, the legislative history and other provisions of the securities laws.

The implication of a private right of action under Section 17(a) of the 1934 Act finds no warrant in either the language of that section individually or the provisions of the 1934 Act as a whole. Not a word indicates that any of the reporting sections was intended to afford the basis for civil liability in damages to anyone who could claim to be a beneficiary of those reports. The 1934 Act as a whole represents a deliberately drawn legislative balance apportioning enforcement among administrative regulation, self-enforcement and liability to third parties. An examination of the text of the 1934 Act and the legislative history persuasively shows that Congress, as part of that regulatory scheme, carefully circumscribed private rights of action in a fashion precluding the claims asserted here.

A. The Text of the Statute Limits Standing to Sue for Violation of Section 17(a) to those Who Purchased or Sold a Security at a Price Affected by the Misstatement.

This Court is now called upon to consider yet another attempt to assert privately a cause of action under the 1934 Act. Such an attempt brings to the fore an analytical process in which this Court has taken pains repeatedly to emphasize, particularly with respect to the securities laws, that "[t]he starting point in every case involving construction of a statute is the language itself." *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 472 (1977); *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 197 (1976) ("*Hochfelder*"), quoting *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 756 (1975) (Powell J. concurring) ("*Blue Chip*").[6]

The text of Section 17(a), unlike all other sections of the 1934 Act in which private remedies have been implied, does not proscribe as unlawful any conduct whatsoever; it simply sets forth certain bookkeeping and reporting requirements.[7]

And, in Section 18(a), Congress squarely limited standing to sue for damages attributable to a false or misleading statement filed with the SEC pursuant to the 1934 Act to those "who in reliance upon such statement, shall have purchased or sold a security at a price affected by such statement," 15 U.S.C. § 78r(a). This is the language which Congress employed. Nowhere in the 1934 Act did Congress indicate any intention to expand the contours of a private right of action for violation of Section 17(a) beyond that permitted in Section 18(a).

Yet the court below dismissed perfunctorily the limitations of Section 18(a). It ignored the reminders by this Court, in both *Blue Chip* and *Hochfelder,* that "the interdependence of the various sections of the securities

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[6] See also, *United States* v. *Bass,* 404 U.S. 336, 339 (1971); Frankfurter, *Some Reflections on the Reading of Statutes,* 47 Colum. L. Rev. 527, 543 (1947).

[7] The Senate Report accompanying the 1975 Amendments (Pub. L. 94-29, 89 Stat. 137) affirms the reporting nature of that section:

> Section 13 of the bill would amend section 17 of the Exchange Act by deleting subsection (a) and inserting several new subsections concerning the authority of the Commission and the appropriate regulatory agencies to prescribe record-keeping, reporting and maintenance requirements and to conduct examinations of persons subject to their respective jurisdictions.

S. Rep. No. 94-75, 94th Cong., 1st Sess. 119 (1975).

laws is certainly a relevant factor in any interpretation of the language Congress has chosen . . . ." 425 U.S. at 206, quoting *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969).

In *Blue Chip*, this Court found it "anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action [with respect to Rule 10b-5] beyond the bounds it delineated for comparable express causes of action [in Section 18]."[8] The holding below is even more anomalous in that it implied a cause of action beyond the bounds within which Congress expressly chose to confine that very cause of action.

The court below was, in effect, forced to reason that Section 18(a) is not applicable because it recognized that its holding exceeded the specific terms of the statute sought to be interpreted and from which the right of action is said to be implied. In view of the clarity of the statutory language, however,

> . . . and mindful that the language of a statute controls when sufficiently clear in its context, *United States* v. *Oregon*, 366 U.S. 643, 648 (1961); *Packard Motor Car Co.* v. *NLRB*, 330 U.S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to [Section 17] by the [court below].

Hochfelder, supra at 201; *see United States* v. *Bass, supra; United States* v. *Campos-Serrano*, 404 U.S. 293, 297-98 (1971); *Toussie* v. *United States*, 397 U.S. 112, 120-22 (1970).

B. The Legislative History: Standing to Sue for Violation of Section 17(a) is Sharply Limited.

The legislative history overwhelmingly demonstrates that Congress meant what it said in Section 18(a) in limiting standing to sue to those who purchased or sold a security at a price affected by a misleading statement filed with the SEC.

Congress considered the wisdom of creating a private right of action for violation of the reporting sections only in connection with fashioning the terms of Section 18(a). Virtually every version of Section 18(a) that was presented to the House or Senate limited standing to sue in the same terms as Section 18(a) in its final form. This consistent uniformity does not reflect Congressional indifference to the limitation of the class of plaintiffs who could bring such actions; to the contrary, Congress consciously intended exactly that limitation. The limitation was insisted on, for example, by Speaker Rayburn in explaining the bill he himself sponsored:

> Mr. Hollister. The gentleman keeps referring to the issuer or the seller. This is a general clause and covers anybody making any kind of statement in any

[8] *Blue Chip, supra* at 736.

The determination below that Congress did not implicitly choose to deny a private right of action under Section 17(a) is based on the court's reasoning that Section 17(a) is distinguishable from the statutory schemes in cases denying a private remedy where a particular agency was vested with exclusive enforcement. In support, the court cited *Cort* v. *Ash*, 422 U.S. 66 (1975); *SIPC* v. *Barbour*, 421 U.S. 412 (1975); *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U.S. 453 (1974) (*"Amtrak"*). *Cort, Barbour* and *Amtrak*, however, do not stand for the proposition, or even suggest, that an implicit Congressional intent to deny a private remedy can only be found where the statutory scheme endows an agency with exclusive enforcement authority. In each case denying such implicit intent this Court based its decision on a careful analysis of the language and structure of the 1934 Act and the legislative history. No such analysis was undertaken by the court below.

kind of document or in any kind of paper that is filed. It includes accountants, lawyers, or any other expert.

Mr. Rayburn. No.

• • • •

[A request of additional time was made]

Mr. Rayburn. I want to read this part of the section to the gentleman:

Who, in reliance upon the statement, shall have purchased or sold a security.

Mr. Hollister. Yes; that is the man who is going to sue. I am talking about the report that is made. This refers to any statement that is made in any report under this bill, if it contains a misleading statement.

Mr. Rayburn. If upon that report somebody bought or sold a security and lost money relying upon the statement that was false.

78 CONG. REC. 8040 (1934).

That intent could hardly be clearer. In the Senate, it was reenforced by Thomas Corcoran, the author with James Landis and Benjamin Cohen of the 1934 Act. After reading Section 18,[9] Corcoran noted "That is the provision of the Securities Act toned down a little," clearly referring to the same purchaser-seller limitation found in Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k and l. *1934 Hearings* at 6564.

Indeed, Congress expressed the concern that, even with the purchaser-seller limitation, the original drafts of Section 18 went too far. Concoran and others were disturbed by a long period of limitations giving rise to the possibility of "blackmail". *1934 Hearings* at 6565. The Institute expressed its concern over the amount of damages originally provided. *1934 Hearings* at 7207-10. These matters were addressed, and Section 18 was accordingly tightened.

[9] Section 17 of The Fletcher Act which later became Section 18.

The decision below, therefore, enjoys no support in the legislative history.[10] The limitation discarded below was consciously required in 1934 and not even in 1975, when Congress rewrote Section 17, was that limitation modified.

The 1975 Amendments were in large part adopted in response to the financial collapse of many brokerage firms and the consequent damage resulting to customers from such failures. Congress authorized the SEC to prepare a Study of Unsafe and Unsound Practices of Brokers and Dealers pursuant to Section 11(h) of the Securities Investor Protection Act of 1970, 15 U.S.C. § 78kkk(h), and that report and the *Securities Industry Study Report of the Senate Subcommittee on Securities* (S. Doc. No. 93-13, 93d Cong., 1st Sess. 1973) were the sources of the amendments. Yet neither Congress nor the SEC ever suggested that

[10] In its scanty treatment of the legislative history, the court below cited Exchange Act releases pertaining to Rule 15c3-1 as support for its conclusion that a private remedy is necessary to accomplish the purposes of Section 17. Beyond the doubtful relevance of the releases to the issue at hand, one of the releases, No. 11,497, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,212, was issued after the effective date of the accrual of the alleged cause of action. While the Institute contends that Section 17 does not provide a private remedy either as originally enacted or amended, such a significant expansion of the legislative scheme should not be undertaken without a thorough analysis of all appropriate sources of legislative intent particularly those related to Sections 17 and 18. In any event the releases can be no broader than the statute itself. *Hochfelder, supra* at 214.

private remedies be granted as a means of protecting broker customers. Instead, Congress sought the achievement of its purposes by strengthening the provisions for SEC oversight and for self-regulation of the securities industry:

> The intent of the bill is not to diminish the role of self-regulation but to strengthen the total regulatory fabric.

S. Rep. No. 94-75, 94th Cong., 1st Sess. 23 (1975).[11]

Further, by 1975, the SEC itself had brought numerous injunctive actions against violators of Section 17(a), one of which was brought in 1973 against Weis for the very violation alleged here. Thus, in 1975, the SEC was fully aware of the very circumstances which prompted its urging below, as *amicus curiae*, that a private remedy be implied. Nevertheless, and notwithstanding the failures of such brokerage firms and the resulting damage to customers, the SEC did not recommend that civil remedies be provided as a necessary supplement to the enforcement mechanisms

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[11] The Senate Report accompanying the 1975 Amendments (Pub. L. 94-29, 89 Stat. 137) adds, in confirming the regulatory nature of the amendments:

> [A]s the Advisory Committee on Broker-Dealer Reports and Registration Requirements recommends: '. . . for reporting purposes each broker-dealer [should] be assigned to a designated principal self-regulator or government regulator who will be responsible for determining the broker-dealer's operative and financial status.' Section 17(d) would provide the SEC with unquestioned authority to accomplish these objectives.

S. Rep. No. 94-75, 94th Cong., 1st Sess. 33 (1975).

existing under the statute. Rather, it recommended solely increased SEC oversight and self-regulatory mechanisms.[12]

Moreover, at the time these amendments were considered, two district courts had held and the Court of Appeals for the Third Circuit had affirmed that Section 18(a) contained the exclusive remedy for violations of the reporting provisions of the 1934 Act.[13] As this Court reasoned with

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[12] Moreover, the adoption by the court below of the "administrative deference" rule is misplaced. This Court in *Piper* v. *Chris-Craft Ind.*, 430 U.S. 1, 41, n.27 (1977) noted the limited value of administrative deference and specifically limited that notion in cases concerning the implication of a private right of action:

> We note, first, that the present position of the SEC is not consistent with the testimony of the SEC Chairman, in the legislative evolution of § 14(e). Even if the agency spoke with a consistent voice, however, its presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one particularly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants. Indeed, in our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case. *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964); *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

[13] Section 18(a) was held to be the exclusive "catch-all" civil liability provision for all the reporting requirements of the 1934 Exchange Act in *In re Penn Central Securities Litigation*, 347 F. Supp. 1327, 1339-40 (E.D. Pa. 1972), *modified on other grounds*, 357 F. Supp. 869 (E.D. Pa. 1973), *aff'd*, 494 F.2d 528 (3d Cir. 1974), *Accord, duPont* v. *Wyly*, 61 F.R.D. 615, 628 (D.Del. 1973). In concluding that Section 18(a) was the exclusive remedy for violation of Section 13(a), the court in *Penn Central* stated:

> Where Congress has specifically authorized a remedy for violation of an act, the courts should not nullify the congressional scheme by implying a right of action on behalf of those not otherwise entitled to recover. 347 F. Supp. at 1340.

Since the enactment of the 1975 Amendments, the *Penn Central* holding has been followed in seven district court cases. *Dewitt* v. *American Stock Transfer Co.*, 433 F. Supp. 994, 1005 (S.D.N.Y. 1977), *modified on other grounds*, 440 F. Supp. 1084 (S.D.N.Y. 1977) (no implied private damage action for violations of §§ 13(a)

(Footnote continued on following page)

respect to the closely related *Birnbaum* rule limiting standing to sue under Rule 10b-5 to purchasers or sellers of securities, Congress's failure to reject this interpretation "argues significantly in favor of [its] acceptance." *Blue Chip, supra* at 733.

C. The Extrinsic Evidence From the Texts of Other Sections of the 1934 Act and of the 1933 Act Show the Error of the Holding Below.

Examination of the interrelated nature of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (the "1933 Act"), and the 1934 Act instructs that Congress did not set the boundaries of civil liability at random. See *Blue Chip, supra* at 727-30. As this Court noted in *Blue Chip, supra* at 728, in each instance where Congress imposed civil liability in 1933 Act it limited the class of plaintiffs to those who suffered a loss related to a securities transaction. The same limitation is found in Section 9(e) of the 1934 Act. The private right of action there enacted employs exactly the same transactional requirement found in Section 18(a). *Blue Chip, supra* at 736. And the "in connection with" language of Section 10(b) accordingly has been interpreted by this Court in *Blue Chip* similarly to require standing as a purchaser or seller.[14]

The decision below is thus a considerable departure from the uniformity found in the other sections of this integrated regulatory scheme as well as a judicial subversion of the terms and intent of Section 18(a) itself. It squarely conflicts with the governing decisions of this Court and should be reversed.

II.

Implication of a private right of action under Section 17(a) beyond the limitations set forth in Section 18(a) raises profoundly disturbing policy implications, provides little guidance to those who would be subject to prospective liability and is unnecessary to achieve Congressional purposes.

It is one thing to posit civil liability in damages on the basis of fraud in connection with a securities transaction. It is another to hold that anyone who Congress thought might derive some benefit from a report required to be filed with the SEC may sue under the 1934 Act for whatever damages he might incur regardless of the absence of any connection with a securities transaction. And it is quite another thing to imply such liability, not just on the part of registered brokers and companies and those persons respon-

and 15(d)); *Lewis* v. *Elam*, [1977-78 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 96,013 (S.D.N.Y. 1977) (§ 13(a)); *Levy* v. *Johnson*, [1976-77 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,899 (S.D. N.Y. 1977) (§ 13(a)); *McLaughlin* v. *Campbell*, 410 F. Supp. 1321 (D. Mass. 1976) (§§ 13(a), 20(b), 20(c)); *Meer* v. *United Brands Co.* [1976-77 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,648 (S.D.N.Y. 1976) (§ 13(a)); *Myers* v. *American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213 (S.D.N.Y. 1975) *aff'd by oral opinion*, 538 F.2d 312 (2d Cir. 1976) (§ 13(d)); *In re Equity Funding Corp. of America SEC Litigation*, 416 F. Supp. 161, 190-91 (C.D. Cal. 1976) (§ 13 has ultimate purpose of investor protection; although a duty to file accurate and complete reports can be implied from the filing requirements, the "sense" of the statute and rules is that they are administrative devices and are not intended to provide private rights to investors, except as might be narrowly provided for in § 18).

[14] This Court's decision in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964) is entirely consistent with the transactional limitations expressly created by Congress. There, this Court held that a recipient of a proxy statement may assert a private cause of action based on a material misstatement contained in that proxy statement in violation of Section 14(a) of the 1934 Act. Such a statement is designed, like a statement made in connection with a purchase or sale of a security (§ 10(b)) and like a statement which influences the price of a security purchased or sold by the plaintiff (§§ 9(e) and 18), to influence the receiver to act. He is thus in a position closely analogous to those whom Congress expressly empowered to sue.

sible for such reports, but on the part of auditors who are one step further removed from the registrant and who render their opinion with respect to financial statements included in such reports.

This, with respect to the reporting requirements to which every registered brokerage house and every registered company are subject, presents that stark spectacle portrayed by Chief Judge Cardozo 48 years ago and recently rejected by this Court: "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931), quoted in *Blue Chip, supra* at 748. Indeed, the risk of such an eventuality under the rule adopted below far exceeds the risk presented in *Blue Chip* where this court dismissed, for similar reasons, the claims under Rule 10b-5 of persons allegedly deceived into holding their securities.

Here, moreover, the exposure of auditors to potentially unlimited liability to an indeterminate class particularly should be avoided since the contours of such liability have not been established. This Court, in determining the appropriate standards of civil liability for violations of the antifraud provisions where a cause of action has been implied, has sought a firm basis for the definition of such standards in both the statutory language and the legislative history. *Hochfelder, supra* at *201.* The language of Section 17(a) and its legislative history provide no such basis to guide either the courts or those who would be subject to potential liability.[15] Thus, in holding that a private right of action

[15] For example, it is not alleged in the proceedings below that the accountants engaged in deliberate or knowing fraud, but that they were guilty of gross negligence or even recklessness. Even under Rule 10(b)-5, the issue of gross negligence or recklessness as a basis for liability was left open by this Court in *Hochfelder, supra* at 194, n.13, which gap has now been seemingly filled by the Court below in regard to Section 17 without any of the guidance from the statute sought by this Court in *Hochfelder, supra.*

exists under Section 17, the Second Circuit has planted an acorn destined to grow into a "judicial oak" at least as substantial as that which prompted the concern of this Court in *Blue Chip.*

It should be self-evident that the process of auditing the financial statements of a company does not yield absolute certitude about the result. The audit function proceeds very largely upon the exercise of judgment and by a process of sampling which in turn rests upon the experience, expertise and informed judgment of the auditor. The product of the audit, as reflected in the auditor's opinion, is again a matter of judgment. Such an indeterminate liability should not be imposed on that process.

The court below took that further step, concluding that, since "neither SEC injunctive actions nor criminal prosecutions will restore to customers the money they have lost," a private right of action against the auditors as the remaining solvent party should be implied. This conclusion misapplies the requirement of "necessity" articulated in *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964), as explained in *Piper* v. *Chris-Craft Ind.,* 430 U.S. 1, 25 (1977) (emphasis supplied):

> The reasoning of these holdings is that, where congressional purposes are likely to be *undermined* absent private enforcement, private remedies may be implied in favor of the particular class intended to be protected by the statute.

This principle was reaffirmed in *Santa Fe Industries, Inc.* v. *Green, supra* at 477:

> . . . we have also recognized that a private cause of action under the antifraud provisions of the Securities Exchange Act should not be implied where it is 'unnecessary to ensure the fulfillment of Congress' purposes' in adopting the Act.

Section 17(a) is not an antifraud provision nor was it enacted for the broad remedial purposes which this Court has attributed to the antifraud provisions. To be sure, Section 17(a) was enacted for the ultimate purpose of protecting investors. But it does not follow that an implied right of action is "necessary" to effectuate that purpose. The reporting provisions and the net capital rule, 17 C.F.R. § 240.15c3-1, are designed to prevent broker failures and to keep the SEC, as well as customers, apprised of the financial status of brokerage firms. H. Rep. No. 91-1613 91st Cong., 2d Sess. (1970). Together they provide an early warning system to alert the SEC to the financial status of brokers in order that measures might be timely taken to ward off financial collapse. To enforce these provisions, the courts are empowered both to enjoin violations and to impose criminal penalties for violations. 15 U.S.C. §§ 78u(e), 78aa. The deterrent value of the threat of damage awards over and above the sanctions presently provided for is speculative at best. *Cf. Piper* v. *Chris-Craft Ind., supra* at 40. Denial of relief to broker's customers under Section 17(a) will not "undermine" Congress' purposes; nor would granting such relief ensure the fulfillment of those purposes.

Moreover, no explanation is given for the creation of a federal remedy, and its concomitant burden on the federal courts, in view of the state law remedies noted in the dissenting opinion of Judge Mulligan. Plaintiffs, in fact, commenced an action for damages in the state courts of New York prior to the commencement of the federal action. No additional federal remedy is necessary to redress their alleged injuries and "[t]he result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation." *Santa Fe Industries, Inc.* v. *Green, supra* at 478.

The holding below goes far beyond improvidently permitting a private cause of action under Section 17(a) in order to allow redundant recourse in a federal court to a presumed "deep pocket." It nullifies at the same time the carefully balanced enforcement scheme based on industry self-regulation, SEC oversight and enforcement, and explicit private remedies enacted and intended by Congress. The holding below was error and should be reversed.

CONCLUSION

For the foregoing reasons, the order of the Court of Appeals for the Second Circuit should be reversed.

Respectfully submitted,

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